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Cheryle A. Broom
King County Auditor

516 Third Avenue, Room W1020
Seattle, WA 98104-3272

(206) 296-1655
TTY 296-1024

MEMORANDUM

DATE: September 28, 2004

TO: Metropolitan King County Councilmembers

FROM: Cheryle A. Broom, County Auditor

SUBJECT: Financial Audit of Workers' Compensation Program

Attached for your review is the report on the financial audit of the Workers' Compensation Program. The audit objectives were to determine if industrial insurance rates were reasonably calculated and county agencies were charged fairly and equitably; if the county had enough funds reserved to fund current and future claims costs; and if internal controls governing the disbursements for medical and time-loss payments were adequate to protect and safeguard county assets.

The audit's general conclusion is that the Workers' Compensation Program has a deficit in reserves which could total about $44.7 million to fund employee benefits claims losses and allocated expenses. This figure is based on the liabilities estimated by an outside actuary for all open claims filed in 2003 and earlier years. Due to a growing unfunded liability, the workers' compensation fund faces an increased risk in meeting its ability to pay future long-term claims obligations. Furthermore, county financial statements do not disclose the full extent of estimated future claims obligations. While the determination of industrial insurance rates is largely equitable, there are some exceptions and errors which should be addressed by the county. Also, the internal controls over issuing for claims payments are generally adequate, but improvements could be made i.e., more supervisory review of register of warrants and list of bills and invoices for payments, and reviewing the need for renewing a fidelity bond for acts of employees dishonesty.

The County Executive's response to the audit generally concurred with the audit findings and recommendations and is contained in the appendices of the report. The response indicates that the county is in compliance with the requirements of the Washington Administrative Code (WAC) with respect to the amount of reserves maintained by the Safety and Workers' Compensation Fund. Nevertheless, the executive concurs with the recommendation to increase fund reserves over time.

The Auditor's Office sincerely appreciates the cooperation received from the management and staff of Safety and Workers' Compensation Section, Human Resources Division, Office of Risk Management, and the Finance and Business Operations Division.

FINANCIAL AUDIT

WORKERS' COMPENSATION PROGRAM

King County

Presented to
the Metropolitan King County Council
Labor, Operations & Technology Committee
by the
County Auditor's Office

Cheryle A. Broom, King County Auditor
Ron Perry, Lead Principal Auditor
Bert Golla, Senior Financial Auditor

Report No. 2004-05
September 28, 2004

Auditor's Office Mission

We conduct audits and studies that identify and recommend ways to improve accountability, performance, and efficiency of county government.

Auditor's Office Vision

We are committed to producing substantive work of the highest quality and integrity that results in significant improvements in accountability, performance, and efficiency of county government. We share a commitment to our mission, to our profession, and to a collaborative work environment in which we challenge ourselves to accomplish significant improvements in the performance of the King County Auditor's Office.

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The King County Auditor's Office provides oversight of county government through independent audits and other studies regarding the performance and efficiency of agencies and programs, compliance with mandates, and integrity of financial management systems. The office reports the results of each audit or study to the Metropolitan King County Council.

The King County Auditor's Office performs its work in accordance with applicable Government Auditing Standards, with the exception of a pending external quality control review.

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Audit and study reports are available on our Web site (www.metrokc.gov/auditor) in two formats: entire reports in PDF format (1999 to present) and report summaries (1992 to present). Copies of reports can also be requested by mail at 516 Third Avenue, Rm. W-1020, Seattle, WA 98104, or by phone at 206-296-1655.

Alternative Formats Available Upon Request

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EXECUTIVE SUMMARY

Overview

Fund Reserves Inadequate

King County self-insures its workers' compensation program. The county's workers' compensation reserve fund is significantly inadequate to cover future claims obligations estimated by the county.

The workers' compensation fund balance is approximately $9 million less than the reserve level established by county code and reported in the county's financial statements.

Deficit Even Larger With Actuarial Estimate

However, the deficit is even larger when one considers the actuarial estimate of future liabilities. According to an outside actuary hired by the county, the estimated future liability is $52.7 million for anticipated losses and allocated expenses (e.g., rehabilitation and legal costs) for all open claims filed in 2003 and earlier years. By the end of 2003, the workers' compensation program had only $8 million in reserves, or a deficit of $44.7 million.

Based on a large and growing unfunded liability, the workers' compensation fund faces an increased risk in meeting its ability to pay future long-term claims obligations. Furthermore, county financial statements do not disclose the full extent of estimated future claims obligations.

Therefore, the county should develop a multi-year plan to build up its reserves to a level established by county code and consider increasing reserves to a level closer to the amount of liability estimated by the outside actuary. Further, the county should appropriately recognize or disclose the total amount of reserves and liabilities in its financial statements. The amount of deficit in the workers' compensation fund should be carefully considered in the development of industrial insurance rates in the future.

While the determination of insurance rates assessed to county agencies is largely equitable, there are some exceptions and errors which should be addressed by the county.

Controls Over Payments Sufficient with One Exception

In general, we found that internal controls over benefit payments were sufficient. One exception is that the Workers' Compensation Program should improve internal controls over issuing warrants. Also, the county should reassess the need for a blanket fidelity bond which would cover employees processing workers' compensation claims. The bond was discontinued last year due to its cost and the county's loss experience. The audit did not disclose any acts of dishonesty but, given the potential risk, recommends reviewing the need and feasibility of a blanket fidelity bond.

Background

This financial audit of the Workers' Compensation Program was included in the Auditor's Office 2004 work program.

The state of Washington requires all employers in the state to provide their employees the benefits of the workers' compensation program. There are basically two ways for employers to cover their employees under the program: Washington State-provided insurance and self-insured program. King County is self-insured and administers its claims processing.

Scope and Objectives

The audit objectives were to determine if industrial insurance rates were reasonably calculated and county agencies were charged fairly and equitably; whether the county has enough funds reserved to fund current and future claims costs; and whether internal controls governing the disbursements for medical and time-loss payments were adequate to protect and safeguard county assets.

<u>Summary of Findings and Recommendations</u>

The County Does Not Have Adequate Reserves to Fully Pay for Future Claims Costs.

Code Requires Adequate Reserves

County Code requires the workers' compensation fund to maintain an excess of assets over liabilities (excluding estimated claims costs) equal to or greater than the estimated liabilities determined by the Human Resources Division of the Department of Executive Services.

Reserves in the county's workers' compensation fund are nearly $9 million less than the liability level ($16.8 million) established by the county and reported in its financial statements. Furthermore, the fund's deficit is growing annually.

In addition, the county's reported liability is substantially less than the $52.7 million potential claims losses estimated by an outside actuary.

Because county reserves are not sufficient to cover estimated liabilities as recorded in the financial statements and actuarial reports, and because the unfunded liability is growing, the audit staff believes that the workers' compensation fund faces an increased risk in meeting its ability to pay future long-term claims obligations.

Actuarial Estimate Not Recognized or Disclosed

County financial statements report the $16.8 million liability level but fail to recognize or disclose the full estimated claims settlement liabilities estimated by the outside actuary. Therefore, the county's financial statements may unintentionally mislead the readers of the financial report on the condition of the workers' compensation fund.

The audit recommends that the county develop a multi-year plan to build up its reserves to a level established by county code and consider increasing reserves to a level closer to the amount of liability estimated by the outside actuary.

The audit also recommends that the Finance and Business Operations Division (FBOD) consider how the reserves level determined by the actuary should be reflected in the county's financial statements to conform to generally accepted accounting principles.

The Methodology to Distribute Industrial Insurance Rates to Agencies Is Generally Fair and Equitable With Some Exceptions.

The county code requires that industrial insurance rates shall be established to generate sufficient revenues to fund the cost of the program functions, including ultimate future claims costs. Every year, the Workers' Compensation Program calculates the industrial insurance rates that agencies are charged to contribute to the fund.

Rate Calculations Fair and Equitable With Exceptions

Our review noted that the program's rate calculations are generally fair and equitable with some exceptions, such as:

- Some jobs were assigned with incorrect risk code classifications.
- One risk code classification is charged with a lower premium rate which is not in proportion to its claims loss experience.
- Transit and Wastewater Treatment Divisions do not use risk code classifications and job classifications to distribute costs to various cost centers.

The audit recommends that the Workers' Compensation Program review risk code classifications assigned to various jobs or occupations and make adjustments when necessary. It should develop a written classification plan, including criteria and detailed descriptions of jobs or occupations, for assigning risk code classifications to various jobs or occupations. **The audit also recommends** that the program, in coordination with the Finance and Business Operations Division, consider calculating the premiums based on risk codes, job classifications, and hours worked by employees for Transit and Wastewater Treatment Divisions.

Supervisory Review Over Register of Warrants to Be Issued and List of Approved Medical and Time-Loss Bills for Payments Is Lacking.
Program staff process and approve bills, invoices, and other documents for payments. This information is sent to FBOD accounts payable section, and warrants are prepared. Program staff distribute the warrants to vendors and injured employees.

Supervisory Review Is Lacking Over Some Payment Records

Our audit noted that the process lacks supervisory review over the register of warrants prepared by accounts payable section and the list of approved medical and time-loss bills for payment. A supervisor's review of the records may minimize the potential occurrence of errors and irregularities.

The audit recommends that the claims supervisor regularly review the register of warrants and list of bills and invoices for payments and place her or his signature on the file once the action is performed.

The County Does Not Have a Fidelity Bond to Ensure Recovery of Loss From Any Acts of Employees' Dishonesty.
The existence of a fidelity bond covers the entire county from loss resulting from acts of employees' dishonesty. When a loss occurs, the county can recoup from the insurance carrier a certain amount in excess of the established deductible amount.

Because of the volume of bills and invoices processed and paid, the county is potentially exposed to hazards of loss from dishonest employees.

The audit staff learned from the Office of Risk Management that the county's fidelity bond expired in June 2003 and has not been renewed since then. The risk manager cited high cost and low claims experience as reasons for non-renewal.

Need for Fidelity Bond Should Be Reviewed

Our review did not disclose any acts of dishonesty or irregularities during the audit but there is still a potential risk of loss. Therefore, we believe the need for and feasibility of a blanket fidelity bond should be reviewed by the Office of Risk Management in collaboration with Finance and Business Operations Division, the Safety and Workers' Compensation Section, and the State Auditor.

The audit recommends that the Office of Risk Management, in coordination with other agencies, should research the insurance market and obtain a fidelity bond if deemed cost-effective.

Summary of Executive Response

The response indicates the executive's concurrence with all of the recommendations. It also notes that the county has taken a "pay-as-you-go" approach to fund the reserve amounts for workers compensation and that the county's reserve far exceeds the minimum level established by state regulation.

Summary of Auditor's Comments

The County Executive's response to the audit explains county policy in meeting its financial obligations for workers' compensation claims liabilities, as noted above. However, we note in our report the county does not comply with a code requirement that the county maintain a reserve equal to the level set by the Human Resources Division. At present, the fund reserve is less than half that amount. The response, however, does agree with our recommendation regarding the need to build up the fund balance over time.

Acknowledgement

The Auditor's Office appreciates the cooperation received from the management and staff of the Workers' Compensation Program, Human Resources Division, Office of Risk Management, and the Finance and Business Operations Division.

1 INTRODUCTION

Background

All employers in the state of Washington are required by state law (Title 51 RCW) to provide their employees the benefits of the workers' compensation program. Workers' compensation is a no-fault system in Washington. As such, employers pay medical costs and a portion of lost wages for injured and occupationally sick employees, and employees generally cannot sue their employers. There are basically two ways for employers to cover their employees under the workers' compensation program: Washington State-provided insurance or an employer's self-insured program. Unlike other states, direct private insurance is not authorized in the state of Washington, although self-insured employers are permitted to reinsure their claims obligations with private insurance companies.

Under the state-provided insurance, employers pay policy premiums for workers' compensation based upon the actual number of hours worked by employees. The premium rates per hour are set by the state's Department of Labor and Industries (L&I). The L&I determines the premium rates for various industries and employees' occupational classifications. Premium levels are based on the risk exposure and claims experience levels of each occupational class.

County Has Self-Insurance Program

The Workers' Compensation Program of the Human Resources Division of the Department of Executive Services administers the county's workers' compensation program within the rules, regulations, and procedures as established by the State Department of Labor and Industries (L&I). The program is self-insured, and its revenues and expenditures are accounted for under the workers' compensation fund, an internal service fund. The revenues are collected from county agencies based on employees' actual hours worked and job classifications. There are two exceptions: the Transit Division (Transit) of the Department of Transportation and Wastewater Treatment Division (WTD) of the Department of Natural Resources and Parks contribute to the fund based on claims losses predicted by an outside actuary.

Exhibit A shows number and amounts of claims filed and paid by the Workers' Compensation Program as of August 26, 2004 from the years filed, 2000 through 2003.

EXHIBIT A

Number of Claims Filed
Year to Date (YTD) Payments Through August 26, 2004

	2000	**2001**	**2002**	**2003**
No. of Claims Filed	1638	1478	1597	1560
Claims Paid				
Indemnity	$7,231,000	$5,777,000	$6,391,000	$4,428,000
Medical	4,089,000	3,723,000	4,588,000	3,274,000
Rehabilitation	207,000	174,000	217,000	100,000
Other expenses	242,000	206,000	246,000	106,000
Total Paid Claims	$11,769,000	$9,880,000	$11,442,000	$7,908,000
Average Payment Per Claim				
YTD - August 26, 2004	$7,185	$6,685	$7,165	$5,069

Note: Claims include closed and opened claims as of August 26, 2004.

SOURCE: Claims Management Database System

Audit Objectives

The audit objectives were to determine if industrial insurance rates were reasonably calculated and county agencies were charged fairly and equitably; whether the county has enough funds reserved to fund current and future claims costs; and whether internal controls governing the disbursements for medical and time-loss payments were adequate to protect and safeguard county assets.

Audit Scope and Methodology

The audit scope was limited to the review of claims files, claims management system, ARMS and IBIS financial records and reports, financial statements, actuarial reports, payment vouchers and supporting documentations, relevant statutes, policies and procedures, and interviews of management and staff.

Commencing Performance Audit

The auditor's office is also commencing a performance audit of the Workers' Compensation Program to explore efficiency and effectiveness issues, particularly in the areas of claim administration, safety and loss prevention in the workplace, and the return-to-work program.

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2 RESERVES AND CLAIMS LIABILITIES

Chapter Summary

The claims filed by employees for workers' compensation benefits are processed by the claims officers of the Workers Compensation Program. When a claim is received, a reserve (incurred loss) is initially set in the amount of $500 on expected medical-only claims. If there is a time-loss claim involved, the initial reserve is set at $2,500 for medical and $1,500 for time-loss indemnity. Payments to employees and vendors are offset against the reserves established for each claim. When the aggregate amount of payments for a claim approaches the reserved amount, the claim officer adjusts the reserve based on the employee's current medical needs and condition and projected future costs. At the end of the year, the Workers' Compensation Program calculates the total reserves for all claims less the amount paid and expected recovery from excess reinsurance to determine the amount of claims obligations.[1] These amounts are recognized in the county's financial statements as short- and long-term claims settlement liabilities.

When Claim Is Received, Reserve Is Initially Set

We found that fund reserves are significantly inadequate to meet future claims obligations. The fund reserves do not meet the level of reserves established by county code. The financial statements show a reserve deficit in total net assets of $8.8 million. However, the total deficit would be approximately $44.7 million, if one includes the full amount of the additional $35.9 million[2] in estimated actuarial liability to close all current open claims as of the end of 2003.

Reserves Are Significantly Inadequate

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[1] "Reinsurance" refers to the county's excess liability insurance which covers the cost of liability claims over a certain amount ("retention level"), which is now $2.5 million. This means the county is self-insured for up to $2.5 million.
[2] Actuarially estimated reserves of $52.7 million less $16.8 million already recognized in the financial statements.

FINDING: The County Does Not Have Adequate Reserves to Fully Pay for Future Claims Costs

The workers' compensation fund can pay for current claims obligations with its available cash and yearly incoming revenues. However, when future claims losses from previously filed claims are considered, the fund is significantly inadequate to pay for all its claims obligations. In addition, the fund exposure to liabilities from future claims is increased due to a high retention level ("deductible") of $5 million from the county's reinsurance for excess coverage.

Fund Balance Is Significantly Insufficient to Cover Estimated Claims Liabilities.

Substantial number of claims filed for workers' compensation benefits take more than a year (some claims take many years) to close. As a self-insured employer, the county has the obligation to establish funds to pay for all the medical and indemnity benefits. To ensure that all claims are paid, the King County Code and Washington Administrative Code require that enough funds are maintained by the county.

Code Requires Net Current Assets Equal to or Greater Than the Claims Liabilities

The County Code (KCC 4.08.070 (G)) requires the workers' compensation fund to maintain an excess of current and other assets over the liabilities (excluding estimated claims settlements) equal to or greater than claims liabilities determined by Human Resources Division of the Department of Executive Services.

Unfunded Liabilities Were $8.8M Per Financial Statements, $44.7M Per Actuary's Projection

Our review noted that the net excess of current assets over current liabilities, excluding claims liabilities, is substantially inadequate to pay for claims liabilities that are recorded in the county's financial statements. These unfunded liabilities amounted to $7.8 million in 2002 and $8.8 million in 2003. The deficit is significantly increased if one includes the actuarial projection of future losses and administrative costs of $35.9 million (excluding claims liabilities recognized in the financial statements) in 2003.

Reinsurance Deductible Is $5M in 2003

The state law allows self-insured employers to insure a portion of its claims obligations with an insurance carrier. The county carries an excess insurance coverage with certain retention level or "deductible." The audit noted that the amount of "deductible" has increased from $500,000 in 2001 to $5,000,000 in 2003.[3] Thus, the county is potentially exposed to a much higher loss from future injury claims. The management of Workers' Compensation Program and Risk Management are currently searching the insurance market for better coverage and lower costs.

The unfunded claims liabilities reflected in the annual financial statements have continuously increased. For the last six years, 1998 through 2003, the total claims settlement liabilities remained underfunded. Exhibit B shows that the percentage of unfunded liabilities, as it relates to total claims settlement liabilities as recognized in the financial statements, increased from 12.3 percent in 1998 to 52.5 percent in 2003.[4]

[3] This amount decreased to $2.5 million in 2004.
[4] The percentage of unfunded liabilities is 84.8 percent when based on actuarial estimate of liabilities for 2003.

EXHIBIT B
Unfunded Claims Settlement Liabilities
From 1998 Through 2003

	1998	1999	2000	2001	2002	2003
Net Current Assets Over Current Liabilities						
Current Assets	$10,416,034	$10,171,662	$10,307,500	$9,840,976	$9,233,810	$9,234,042
Current Liabilities (excluding claims settlement liabilities)	594,922	748,206	1,151,894	1,464,310	1,093,478	1,263,893
Net Current Assets Over Current Liabilities	9,821,112	9,423,456	9,155,606	8,376,666	8,140,332	7,970,149
Estimated Claims Settlement Liabilities						
Current Claims Settlement Liabilities	6,720,000	7,230,000	7,452,000	7,500,000	9,582,000	10,072,938
Long-term Claims Settlement Liabilities	4,480,000	4,820,000	4,968,000	5,000,000	6,388,000	6,715,292
Estimated Claims Settlement Liabilities	11,200,000	12,050,000	12,420,000	12,500,000	15,970,000	16,788,230
Unfunded Claims Settlement Liabilities	-$1,378,888	-$2,626,544	-$3,264,394	-$4,123,334	-$7,829,668	-$8,818,081
Percentage of Unfunded Claims Settlement Liabilities	-12.31%	-21.80%	-26.28%	-32.99%	-49.03%	-52.53%

SOURCE: County's Comprehensive Annual Financial Reports

Fund Experienced Losses

Our review noted that the workers' compensation fund experienced losses (total expenditures exceeded revenues) every year. Some explanations for these losses include:

- Fewer actual employees hours than what was estimated during the budget process; therefore, revenue was less than the budgeted amount;
- Investment earnings were lower than they used to be;
- Medical and time-loss benefits have increased due to increases in vendors' costs and indemnity benefits payments (e.g., health benefits and overtime are factored into time-loss payments per recent court decisions).

Starting in 2004, the program changed its methodology for collecting workers' compensation premiums from agencies by automatically transferring 1/12th of budgeted revenues to workers' compensation fund every month. This was intended to ensure that all the budgeted revenues would be collected. However, this does not address the other issues which contributed to the losses each year.

Exhibit C, shows that in almost every year from 1998 through 2003, the program experienced losses and the fund balance has decreased. The decreasing fund balance combined with a growing unfunded liability has increased the risk of the fund's ability to pay for future liabilities.

EXHIBIT C
Revenue, Expenditures, and Net Income or Loss
From 1998 Through 2003

	1998	1999	2000	2001	2002	2003
Revenues						
Contributions	$12,773,046	$13,046,466	$13,862,118	$16,142,069	$17,887,428	$20,980,067
Interest Income	597,544	554,438	701,457	544,944	308,097	104,413
Miscellaneous	105,682	63,590	1,243	-1,597	0	-7,176
	13,476,272	13,664,494	14,564,818	16,685,416	18,195,525	21,077,304
Expenditures						
Contract Services and Other Charges	11,308,330	12,830,378	12,238,341	13,834,502	18,161,093	17,969,510
Other Expenditures	1,942,945	2,032,548	3,000,453	3,743,520	3,728,877	4,150,890
	13,251,275	14,862,926	15,238,794	17,578,022	21,889,970	22,120,400
Net Income (Loss)	$224,997	-$1,198,432	-$673,976	-$892,606	-$3,694,445	-$1,043,096

SOURCE: Comprehensive Annual Financial Reports

Fund Needs to Build Up Reserves

The workers' compensation fund is an internal service fund; as such, its objective is not to make a profit but to recover the cost of operations and meet the objectives of the financial plan. Thus, an adjustment in the rates will be needed in order to build up the fund balance and reduce the fund's deficit.

The Workers' Compensation Program recognizes that there is a significant deficit in the fund reserved to meet all future claims settlement liabilities. The audit staff noted, however, that the program's financial plan does not indicate any initiative to increase the fund reserves by factoring the deficit into the development of future industrial insurance rates.

The Actuarially Estimated Reserves of $52.7 Million Were Not Recognized or Disclosed in the County's Financial Statements.

Financial Statements Show $16.8M Claims Liabilities in 2003

The Workers Compensation Program submits a report to the Finance and Business Operations Division (FBOD) on the amount of estimated claims settlement obligations at the end of the year. The program determines the claims settlement liabilities from the estimated incurred (reserves) losses, less the amounts already paid and estimated amounts to be recovered from reinsurance. These estimated claims losses are recognized in the books as current and long-term claims settlement liabilities. The county's comprehensive annual financial reports showed the total claims liabilities of $15,970,000 and $16,788,000 in 2002 and 2003, respectively.

Actuary Estimated $52.7M Claims Liabilities; Amount Not Disclosed in Financial Statements

Our review noted, however, that the county's claims obligations were potentially much greater than what were reflected in the published financial statements. According to the report prepared by the outside actuary, the county's expected reserves, including loss and allocated loss expense, totaled $43.6 million in 2002 and $52.7 million in 2003. The actuary's estimates showed a potential understatement of liabilities that were recognized in the county's financial statements by $27.6 million and $35.9 million in 2002 and 2003, respectively. Failure to recognize or disclose the full estimated claims settlement liabilities in the county's financial statements may unintentionally mislead the readers of the financial report on the condition of the workers' compensation fund. Based on the amount of unfunded liabilities as recorded in the financial statements and actuarial reports, the audit staff believes that the workers' compensation fund faces an increased risk in meeting its ability to pay future long-term obligations.

To arrive at the actuarial estimates of reserves, the actuary's study analyzed the payments and incurred loss development methods, the loss per exposure method, average loss per claim method and history of large claims. The actuary also held discussions with management about the county's exposures and losses.

We were told by FBOD staff that they were not aware or advised of the actuary's reports. Hence, the additional estimated liabilities or reserves were not recognized in the county's financial statements. So those statements do not conform to the generally accepted accounting principles.

GASB Requires Recognition or Disclosure of Claims Liabilities

Government Accounting Standards Board (GASB) Statement No. 10 requires that if a claim is asserted and it is probable that a loss (the future event or events that are likely to occur) has been incurred and that loss is reasonably estimable, the expenditure/expense and liability should be recognized in the financial statements. If no accrual of liability is made for a loss contingency because one or both of the conditions (it is probable that one or more future events will occur and loss can be reasonably estimated) are not met, disclosure of the contingency in excess of the reinsured loss should be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred.[5]

[5] GASB Statement No. 10, paragraphs 53 and 58.

FBOD staff advised us that they will consider appropriate accounting treatment for the actuarially estimated reserves for claims losses and allocated expenses.

RECOMMENDATION 1 The county should develop a multi-year plan to build up its reserves to a level established by county code and consider increasing reserves to a level closer to the amount of liability estimated by the outside actuary.

RECOMMENDATION 2 Finance and Business Operations Division should consider how the reserves level determined by the actuary should be reflected in the county's financial statements to conform to the generally accepted accounting principles.

3 INDUSTRIAL INSURANCE RATES AND AGENCY CHARGES

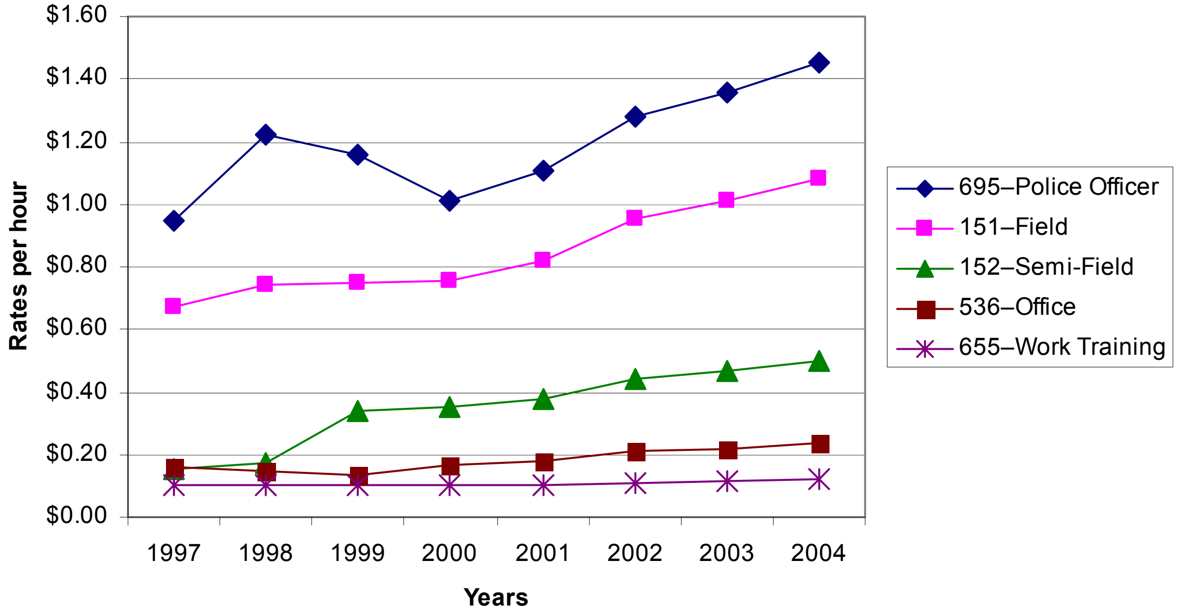
Chapter Summary

Premiums Calculated Every Year

As a self-insured employer, King County maintains a workers' compensation fund in which income from industrial insurance rates, commonly known in the insurance industry as "premiums," are accounted for as revenues. Every year, the Workers' Compensation Program, in coordination with the Office of Management and Budget and assistance of the outside actuary, calculates how much premium revenue to collect from county agencies. These collected premiums and other revenues such as investment earnings are used to pay for medical expenses, time-loss indemnity, administration, and other expenses.

Exhibit D shows the industrial insurance rate per hour for each risk code classification that was charged by the program to various King County agencies, from 1997 through 2004. This does not include the Transit Division (Transit) and the Wastewater Treatment Division (WTD), because risk codes and job classification system is not used in calculating their industrial insurance rate.

EXHIBIT D
Industrial Insurance Rates per Hour by Risk Code Classification
1997 - 2004



SOURCE: Workers' Compensation Program

Generally, during the period from 1997 through 2004, the average annual increase of the industrial insurance rates for all risk code classifications ranges from 3 percent to 7.5 percent, except for 152–Semi-Field with 27.3 percent. The management claimed that the increase in 152–Semi-Field was to adjust its low base rate to a level that fairly reflects its potential exposure to risk and claims experience.[6]

The workers' compensation fund collected revenues of $17,887,000 and $20,980,000 in 2002 and 2003, respectively.

Premiums Not Enough to Cover Costs

We found that the premiums collected for workers' compensation were not adequate to cover claims costs, and administrative and other expenses. However, the methodology of distributing industrial insurance rates to agencies was generally fair and equitable with some exceptions. The program could improve its

[6] The auditors were also told that the state has discontinued the 152 risk code and folded into risk code 151–Field.

process by reviewing the assigned risk code classification for various job classifications; using current claims loss experience in the calculation to derive accurate rates per hour for each risk code classification; and using risk codes, job classifications, and hours worked by employees to calculate premium rates for Transit and Wastewater Treatment Divisions.

FINDING: The Methodology to Distribute Industrial Insurance Rates to Agencies Is Generally Fair and Equitable With Some Exceptions

The county code requires that industrial insurance rates shall be established to generate sufficient revenues to fund the cost of the program functions and future claims costs.

Every year, the Workers' Compensation Program calculates the industrial insurance rates that agencies contribute to the fund. An actuary analyzes the claim payment history and other factors to predict the claim costs for the next budget year. The administration and overhead costs are allocated based on the percentage of predicted claims costs. The estimated revenues are generated by multiplying the projected actual number of hours worked by the rate per hour for each risk code classification.[7]

The actuary analyzes the Transit and WTD claims data to estimate their costs which are set in lump sum for the year. Transit and WTD each contributes to the fund based on their percentage of total claims costs.

[7] Due to undercollection of revenues resulting from fewer hours worked compared to projected hours, the method of collection was changed to transferring 1/12th of budgeted industrial insurance amount to the workers' compensation fund every month.

Rate Calculations Generally Fair and Equitable With Exceptions

Our review noted that the program's calculation is generally fair and equitable in all material respects. However, we found some areas for improvement, such as: 1) Some jobs were assigned with incorrect risk code classifications; 2) One risk code classification is charged with a premium rate lower than its claims loss experience; and 3) Transit and WTD do not use risk code classifications and job classifications to distribute costs to various cost centers.

Some Jobs Were Assigned With Incorrect Risk Code Classifications

The program spreads the predicted claims costs for King County portion to six risk code classifications. These classifications and corresponding rate-per-hour premium for 2004 are shown in Exhibit E.

EXHIBIT E
Risk Code Classifications, Rates, and Examples of Job Classifications

Risk Code Classifications	2004 Rates Per Hour	Examples of Job Classifications
151–Field	$1.0810	Animal Control Officer, Asbestos Technician, Fire Investigator, Custodian, Mechanic, Microbiologist
152–Semi-Field	$0.5001	Appraiser, Autopsy Assistant, Building Service Supervisor, Assessor, Case Manager, Civil Engineer
536–Office	$0.2360	Staff Attorney, Auditor, Contract Monitor, Confidential Secretary, Computer Analyst, Controller, Councilmember, Information Officer
655–Work Training	$0.1248	WTP Enrollee
695–Police Officers	$1.4540	Airport Police, Detective, Captain, Police Officer, Sergeant, Sheriff, Major, Lieutenant, Police Cadet
536–Jurors/Elections	$0.1200	Juror, Election Volunteer

SOURCE: Workers' Compensation Program

Some Jobs Are Rated With Higher Risk Codes

Our review noted that there are some jobs or occupations that are rated with higher risk codes than appropriate, thus, contributing more to the fund. Some other jobs or occupations are rated with lower risk codes than appropriate, hence, contribute less amount to the fund. Some examples of occupations that are rated with higher risk code are:

> Risk code 151–Field: cashiering system tech, plans examiner, process analyst III, and X-ray technician.

We believe that these jobs should be assigned with risk code 536–Office, as employees with these occupations have less potential for loss as reflected in claims experience and Washington State Department of Labor and Industries (L&I) practice.

Some examples of jobs that are rated low although they are potentially exposed to higher risks are as follows:

> Risk code 536–Office: automotive machinist, civil engineer, construction management, and epidemiologist.

We believe that these jobs are exposed to higher risks and should be rated risk code 151–Field instead of 536–Office, as employees with these occupations have higher potential for loss as reflected in claims experience and state L&I practice.

The effect of misclassified risk code classifications is that certain agencies with employees who are exposed to low risks and are charged with higher rates subsidize other agencies with employees who are exposed to more risks but are charged with lower per-hour rate of premium.

The Human Resources Division and/or the Workers' Compensation Program staff assign the risk codes classifications. The audit noted that there are no existing written guidelines or classification plan which would provide a description of each job, potential risk exposure of each job, and the type of risk codes each job should be assigned to. Such a classification plan would provide for consistent assignment of risk codes for each job, thus, enhancing fair and equitable charge of workers' compensation premiums.

RECOMMENDATION 3

The Workers' Compensation Program should review risk codes classifications assigned to various jobs or occupations and make adjustments when necessary.

RECOMMENDATION 4

The Workers' Compensation Program should develop a written classification plan, including criteria and detailed descriptions of jobs or occupations, for assigning risk codes classification to various jobs or occupations.

One Risk Code Classification Is Charged With a Premium Rate Lower than Its Claims Loss Experience.

Claims Experience Differs From Estimate

The estimated revenues for all agencies except Transit and WTD are collected based on the rates per hour and the number of hours for each risk code classification. The rates per hour are calculated using the predicted claims costs, the claims experience, and the estimated number of hours for each risk code classification for the following year. Our review of claims from the claims management database shows the actual percentage of claims losses differs from what was used in the calculation of estimated revenues. Specifically, the review noted that risk code classification 695–Police Officers had an actual claims experience of 23 percent, but the program used only 18 percent. The 18 percent was based on calculations prepared several years ago and not updated to reflect recent claims experience. As a result, the agencies with 695–Police Officers (primarily the Sheriff's Office) are paying about $479,000 less in 2004 than they should, and other risk classifications are paying more than they should. This inequity occurred because the historical practice of using the most recent five years of claims loss data was not used to adjust the rates.

RECOMMENDATION 5

The Workers' Compensation Program should use the last five-years of claims loss experience when calculating industrial insurance rates.

Transit and Wastewater Treatment Divisions Do Not Use Risk Code Classifications and Job Classifications to Distribute Costs to Various Cost Centers.

Claims Costs Based on Predicted Claims

Transit and WTD derive their shares of workers' compensation costs from claims losses predicted by an outside actuary based on the dollar value of predicted claim and then distributed to cost centers based on the number of employees. On the other hand, the remaining King County portion (all agencies under the Management Science America (MSA) payroll system, except Transit and WTD) of costs is distributed by using the rates per hour and number of hours worked by employees. With the MSA payroll, the King County agencies' contributions are transferred to the fund every payday. The Transit and WTD (users of Peoplesoft payroll system) share the costs between them in lump sum amount which is distributed to cost centers based on their number of employees. Peoplesoft payroll system is not customized to calculate workers' compensation contribution every pay period. However, the system can sort and determine the actual number of hours worked by employees and by job classification. These data could be used in the calculation of rates for Transit and WTD.

Distribution of Costs for Two Divisions Not Based on Claims Experience for Jobs

The approach for distribution of claims costs used for Transit and WTD does not consider risk exposures and claims loss experience for all their jobs and occupations. Consequently, the workers' compensation benefit costs are not equitably distributed to their various cost centers. The audit staff found that the workers' compensation classification system is an objective method of collecting premiums to pay for the workers' compensation benefits. The method is fair and has a relationship to their exposure to hazard and potential for loss; it is more accurate and equitable than using just the number of employees.

RECOMMENDATION 6

The Workers' Compensation Program, in coordination with the Finance and Business Operations Division, should evaluate the use of risk codes and job classifications to calculate workers' compensation contributions by Transit and WTD.

4 INTERNAL CONTROLS OVER BENEFITS PAYMENTS

Chapter Summary

The Workers' Compensation Program staff process and approve billings, invoices, and other supporting documents for payment of medical and time-loss indemnity. A list of approved medical and time-loss billings is sent to the Finance and Business Operations Division's accounts payable for issuance of warrants. Accounts payable prepares and sends the register of warrants to be paid to program staff for review. Subsequently, the warrants are prepared and sent to program staff for distribution to vendors and employees. Program staff mail these warrants, generally with accompanying explanation of benefits, to payees. The program issues three batches of warrant payments per week.

Controls Were Generally Sufficient

We reviewed the processing and payments of medical and time-loss bills and invoices and related accounting records to determine if internal controls are in place to safeguard program assets. We found that, in general, these controls were sufficient.

The audit notes that the claims supervisor needs to review regularly the register of warrants and list of medical and time-loss bills for payments. The county's Risk Management Office should also consider the feasibility of obtaining a blanket fidelity bond to protect the county from acts of employees' dishonesty.

FINDING: Supervisory Review Over Register of Warrants to Be Issued and List of Approved Medical and Time-Loss Bills for Payments Is Lacking

After bills are reviewed, claims officers indicate their approval on the claim file in the claims management database system. This information is exported to IBIS accounts payable for preparation of warrants. Before warrants are issued, a register of warrants is sent to program administrative staff for reconciliation and review. Then warrants are prepared by IBIS accounts payable and sent to program administrative staff for distribution to payees.

Supervisory Review Is Lacking Over Some Payment Records

There is no indication that the claims supervisor reviews the register of warrants prepared by IBIS accounts payable or the list of approved medical and time-loss payments prepared by program staff. To strengthen internal controls over benefit payments, a supervisor should review these documents to minimize the potential occurrence of errors and irregularities. Our review, however, did not disclose any occurrence of errors or irregularities.

RECOMMENDATION 7

The claims supervisor should review the register of warrants and the list of bills and invoices for payments regularly and indicate her/his signature on the document when this action is performed.

FINDING: The County Does Not Have a Fidelity Bond to Ensure Recovery of Loss From Any Acts of Employees' Dishonesty.

The existence of fidelity bond to cover the county for loss from employees' dishonesty is an important element of a good internal control system. When a loss occurs, the county can recoup from the insurance carrier an amount in excess of the established deductible amount. With blanket coverage, the county is covered from loss committed by any dishonest employee.

Because of the volume of bills and invoices and the amount involved in the payment of workers' compensation benefits, the county is potentially exposed to hazards of loss from dishonest employees.

The audit staff learned from the Office of Risk Management that the county's fidelity bond expired in June 2003 and has not been renewed since then. The risk manager cited high cost and low risk exposure as reasons for non-renewal. If the county experiences a loss due to an act of employee dishonesty or fraud, the loss would be absorbed by the county, which is self-insured.

Re-Evaluate the Need for Fidelity Bond

Our review did not disclose any acts of dishonesty during our audit. However, given the financial control risk issue, the Office of Risk Management should re-evaluate the need to have a fidelity bond in place. This should be done in coordination with the Finance and Business Operations Division, the Safety and Workers' Compensation Section, and the State Auditor. The bond would cover all county employees, including staff of Workers' Compensation Program.

RECOMMENDATION 8

The county's risk manager, in coordination with the Finance and Business Operations Division, the Safety and Workers Compensation Section, and the State Auditor, should re-evaluate the need for a blanket fidelity bond, research the insurance market, and obtain the bond if it is deemed economically feasible.

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APPENDICES

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LIST OF RECOMMENDATIONS & IMPLEMENTATION SCHEDULE

Recommendation 1:
Develop a multi-year plan to build up its reserves to a level established by county code and consider increasing reserves to a level closer to the amount of liability estimated by the outside actuary.

Implementation Date: First quarter of 2005.

Estimate of Impact:
Increases reserves by $8.8 million to match the total estimated claims liabilities of $16.8 million. After meeting this level, build up reserves closer to $52.7 million. Enhances the county to meet future claims obligations when they become due. The building up of reserves will increase the premium rates that agencies contribute to the workers' compensation fund.

Recommendation 2:
FBOD should consider how the reserves level determined by the actuary can be reflected in the county's financial statements to conform to the generally accepted accounting principles.

Implementation Date: Second quarter of 2005 and included in the 2004 CAFR report.

Estimate of Impact:
Recognition and/or disclosure of actuarial estimates conform to generally accepted accounting principles and show accurate picture on the financial condition of the workers' compensation fund.

Recommendation 3:
Review risk codes classifications assigned to various jobs or occupations and make adjustments when necessary

Implementation Date: First quarter of 2005.

Estimate of Impact:
Enhances fairness and equity in the distribution of claims costs to all county agencies.

Recommendation 4:
Develop a written classification plan, including criteria and detailed descriptions of jobs or occupations, for assigning risk codes classification to various jobs or occupations.

Implementation Date: Fourth quarter of 2004.

Estimate of Impact:
Enhances fairness and equity in the distribution of claims costs to all county agencies.

Recommendation 5:
Use the last five-years of claims loss experience when calculating industrial insurance rates.

Implementation Date: Complete.

Estimate of Impact:
Enhances fairness and equity in the distribution of claims costs to all county agencies.

Recommendation 6:
Evaluate the use of risk codes and job classifications to calculate workers' compensation contributions by Transit and WTD.

Implementation Date: Fourth quarter of 2004.

Estimate of Impact:
Enhances fairness and equity in the distribution of claims costs to all county agencies.

Recommendation 7:
The claims supervisor should review the register of warrants and the list of bills and invoices for payments regularly and indicate her/his signature on the document when this action is performed.

Implementation Date: Third quarter of 2004.

Estimate of Impact:
Strengthens internal controls to prevent loss of county assets or enhances timely detection of errors or irregularities.

Recommendation 8:
Re-evaluate the need for a blanket fidelity bond, research the insurance market, and obtain the bond if it is deemed economically feasible.

Implementation Date: Fourth quarter of 2004.

Estimate of Impact:
Ensures recovery of loss when act of employee's dishonesty occurs. The cost of the fidelity bond will be distributed to all county agencies.

EXECUTIVE RESPONSE

King County
Ron Sims
King County Executive
516 Third Avenue, Room 400
Seattle, WA 98104-3271
206-296-4040 206-296-0194 Fax
TTY Relay: 711
www.metrokc.gov

September 24, 2004

Cheryle Broom
King County Auditor
Room 1020
C O U R T H O U S E

Dear Ms. Broom:

Thank you for the opportunity to review your Report of the Financial Audit of the Workers' Compensation Program. I appreciate the effort the audit represents and concur with many of the findings and recommendations. I look forward to the discussion of the final audit at the September 28, 2004, meeting of the Labor, Operations and Technology Committee. This letter and the associated enclosure respond to the findings and recommendations presented in the proposed final report.

As a preface to my detailed responses, it is important that you are aware of the orientation with which the Executive branch has approached the Safety and Worker's Compensation fund's management for many years. Specifically, our approach has been based on a practical annual analysis completed by the Finance and Business Operations Division (FBOD), which determines the county's year to year projected liability. In addition, our approach takes into account the requirements of the WAC which regulates the conduct of self-insured entities.

I appreciate the concerns raised with reference to fund balance. The governing regulations do indicate that a degree of interpretation is warranted in making the determination of the appropriate level of reserves. Towards this end, although the reserve fund does not equal the total amount of future ultimate liabilities, it is important to consider that the workers' compensation obligations (such as 20 to 30 year pension liabilities) are long term liabilities and will be financed through the annual industrial insurance rate setting function. Industrial Insurance rate collections are similar to a "pay as you go" approach, which ensures that each fund is held responsible for making contributions to the maintenance of the fund target level. Also, the state self-insured workers' compensation regulations recognize the long term nature of such fund's liability profile. Given this, WAC 296-15-151 (2) establishes that public employers shall establish fund reserves at 25 percent of the future liabilities. The relevant governing language provides:

> "**WAC 296-15-151** (2) **How does a public entity provide surety?** By July 1 of each year, each public entity must submit its public entity surety certification. A public entity's surety certification must demonstrate that it has sufficient revenues in its next budget to meet its estimated claim costs for the next fiscal year by documenting:

Cheryle Broom
September 24, 2004
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a. The estimated claim liabilities;
b. Source of revenues, detailing accounts identified for self insurance obligations; and
c. How the cumulative reserve (twenty-five percent of the required surety) is funded. Show the account balance.

Currently, King County exceeds the 25 percent WAC requirement by maintaining a reserve balance of near 50 percent.

For ease of presentation, our responses are contained in the attachment in the format requested by your office. If you require additional information, please contact Human Resources Management Division Director Anita Whitfield, at 206-296-1737.

Sincerely

Ron Sims
King County Executive

Enclosure

cc: Kurt Triplett, Chief of Staff, King County Executive Office
Sheryl Whitney, Assistant County Executive
Paul Tanaka, County Administrative Officer, Department of Executive Services (DES)
Steve Call, Director, Office of Management and Budget
David Lawson, Manager, Executive Audit Services
Anita Whitfield, Director, Human Resources Division (HRD), DES
Bob Cowan, Director, Finance and Business Operations Division (FBOD), DES
Michael Frawley, Deputy Director, HRD, DES
Ben Leifer, Support Services Manager, HRD, DES
Connie Griffith, Financial Management Manager, FBOD, DES
Tim Drangsholt, Safety and Claims Manager, HRD, DES

Executive Response to Report of the Financial Audit of the Workers' Compensation Program

Recommendation	Executive Response	Schedule for Implementation	
1. The county should develop a multi-year plan to build up its reserves to a level established by county code and consider increasing reserves to a level closer to the amount estimated by the outside actuary.	We concur with the recommendation. A multi-year plan is needed to increase the reserves in the workers' compensation fund. The method used to estimate and report future liabilities will be investigated by the Finance and Business Operations Division (FBOD) in conjunction with the Office of Safety and Claims and its actuary. The appropriate liability amount determined in accordance with generally accepted accounting principles (GAAP) will be used in fund balance-building plans. The appropriate level of funding as defined in the RCW and required by GAAP will be used to determine the appropriate build-up of the level of reserves over a reasonable period of time and will be agreed to by the FBOD, OMB and the HR Division, Office of Safety and Claims.	First quarter of 2005	The workers' compensation fund may be considered under-funded dependent on the method used to estimate future liabilities. Any efforts to increase the fund balance will be a multi-year endeavor. The determination of number of years will be a function both of King County's financial capacity as well as the development of a prudent plan to assure that risks are appropriately addressed.
2. Finance and Business Operations Division should consider how the reserve level determined by the actuary should be reflected in the county's financial statements to conform to generally accepted accounting principles.	We concur with this recommendation. The FBOD will consider how the reserve levels determined by the actuary should be reflected in the county's financial statements.	To be completed in the second quarter of 2005 and included in the 2004 CAFR report.	
3. The workers' compensation program should review risk code classifications assigned to various jobs or occupations and make adjustments when necessary.	We concur with the recommendation. The review is currently underway. The Office of Safety and Claims will work with the FBOD, other units within the Human Resources Division, and the Office of Management and Budget (OMB) in order to establish the appropriate degree of quality controls for future coding. All of the county job titles and the corresponding industrial insurance codes will be reviewed and corrections implemented.	First quarter, 2005.	

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EXECUTIVE RESPONSE (Continued)

Recommendation	Executive Response	Schedule for Implementation	
4. The workers' compensation program should develop a written classification plan, including criteria and detailed descriptions of jobs or occupations, for assigning risk code classifications to various jobs or occupations.	We concur with the recommendation. The current industrial insurance classifications were developed by the Department of Labor and Industries. The Office of Safety and Claims will expand the classification definitions as appropriate in order to increase the accuracy and consistency of rate administration.	The fourth quarter of 2004.	
5. The workers' compensation program should use the last five years claims loss experience when calculating industrial insurance rates.	We concur with the recommendation. The single example which gave rise to the Auditor's comment has been corrected. The risk classification rates were adjusted to reflect the prior year's loss experience during the 2005 rate setting process during May 2004. The practice will continue annually in the future.	.Complete.	
6. The workers' compensation program, in coordination with the Finance and Business Operations Division, should calculate worker's compensation contributions by using risk codes and job classifications to calculate workers' compensation contributions by Transit and WTD.	We concur with the recommendation. The Transit and WTD 2004 and 2005 industrial insurance charges will be broken down by both loss experience and organization. The information will be provided to each division's finance office. Future budgets will integrate the further breakdown of charges into the budgeting process.	Fourth Quarter 2004.	
7. The claims supervisor should review the register of warrants and list of bills and invoices for payments regularly and indicate her/his signature on the document when this action is performed.	We concur with the recommendation.	3rd quarter of 2004.	
8. The county's risk manager, in coordination with the Finance and Business Operations Division, the Workers' Compensation Section, and the State Auditor, should re-evaluate the need for a blanket fidelity bond, research the insurance market and obtain the bond if it is deemed economically feasible.	We concur with the recommendation. The County's Risk Manager will research the insurance market in coordination with other agencies to determine whether a fidelity bond is advisable and economically appropriate.	Fourth quarter of 2004	

EXECUTIVE RESPONSE (Continued)

ABBREVIATIONS

FBOD	Finance and Business Operations Division
GASB	Government Accounting Standards Board
L&I	State Department of Labor and Industries
Transit	Transit Division, Department of Transportation
WTD	Wastewater Treatment Division, Department of Natural Resources and Parks

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